

General Information Letter: Addition modification for other states' taxes deducted in computing taxable income of a trust claiming foreign tax credit for those taxes should be passed through to the beneficiaries if the deduction was passed through to them.

November 22, 2002

Dear:

This is in response to your inquiry regarding the Error Notice Response received by the above-referenced taxpayer. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us.

On its 2001 Form IL-1041, the taxpayer claimed a credit for income taxes paid to Wisconsin. The taxpayer had deducted the taxes paid to Wisconsin in computing its federal taxable income, and was therefore required to add back that deduction when it claimed the credit, pursuant to Section 203(c)(2)(F) of the Illinois Income Tax Act (35 ILCS 5/203). However, because the taxpayer had allocated the deduction to "distributable net income," and so passed the deduction to its beneficiaries, it allocated the add-back to its beneficiaries. In addition, it reported the add-back on Line 2b of the Form IL-1041, rather than on Line 2d as directed in the instructions.

You provided me with a copy of Rev. Rul. 74-257, in which the IRS ruled that state income tax imposed on capital gains allocated to corpus could nevertheless be deducted in computing distributable net income, and therefore passed through to the beneficiaries.

Response

Section 601(b)(3) of the Illinois Income Tax Act (35 ILCS 5/601) provides in part:

The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year. . . . The credit provided by this paragraph shall not be allowed if any creditable tax was deducted in determining base income for the taxable year.

Section 203(c)(2)(F) of the Illinois Income Tax Act requires a trust to add back to its federal taxable income:

For taxable years ending on or after January 1, 1989, an amount equal to the tax deducted pursuant to Section 164 of the Internal Revenue Code if the trust or estate is claiming the same tax for purposes of the Illinois foreign tax credit under Section 601 of this Act.

The instructions for the Form IL-1041, Line 2d, state that this add-back must be allocated to the trust rather than to the beneficiaries. Pursuant to this provision, the Department denied the credit claimed by the taxpayer because it had allocated the add-back to the beneficiaries.

This instruction was written on the erroneous belief that, if a trust claimed a federal income tax deduction for a state income tax imposed on income of a trust that is not distributed or deemed distributed to the beneficiaries, the deduction would be not be allocated to the income distributed to the beneficiaries. Under that misconception, any deduction allocated to the beneficiaries must have been imposed on income distributed to them, which Illinois does not tax. Accordingly, a tax allocated to the beneficiaries could not qualify for the credit under Section 601(b)(3) of the Illinois Income Tax Act, which is allowed for taxes imposed on income taxed by both Illinois and another state.

Rev. Rul. 74-257 proves that this instruction is mistaken. Accordingly, the credit claimed by the taxpayer in this case should have been allowed, even though the add-back for the Wisconsin tax was allocated to the beneficiaries of the trust. The instruction will be corrected in future publications.

I apologize for this mistake, and for the delay in issuing this letter.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel – Income Tax